Myrmikan Update

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Gold's Mid-Cycle Correction

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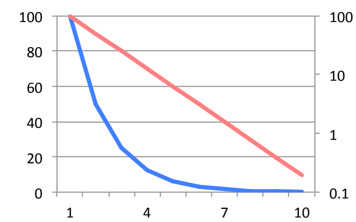
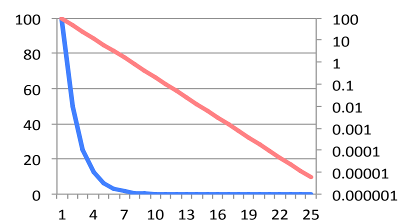
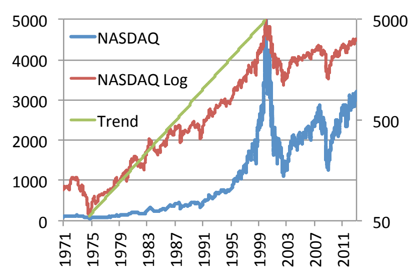
In the 5th century B.C., Zeno of Elea pointed out: "That which is in locomotion must arrive at the half-way stage before it arrives at the goal." Upon reaching the mid-way point, there is a new half-way point at which the object in motion must reach, and so on to infinity. Thus, an object can never reach its destination because it must pass through an infinite number of way-stops first. Aristotle solved Zeno's riddle by pointing out that each step occurred in only half the time, proving that space and time are infinitely divisible and anticipating modern calculus.



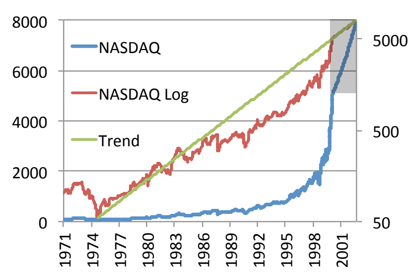
Nevertheless, Zeno's simple puzzle does aid in understanding logarithms, an appreciation of which is central to professional investing. Imagine Zeno's arrow begins 100 yards from its target, and for each constant unit of time it closes half the gap. The blue line on the top graph shows the distance of the arrow from its target as it asymptotically approaches zero. The red line is the same graph plotted on a logarithmic scale. The log scale reveals the rate of change, which in this case is constant at 50% per period.



The next graph no doubt would have delighted Zeno: it is the same as above only carried out 25 periods instead of 10. The blue line has changed shape, but the red line is the same as the first graph, since the rate of change is constant. The change in the blue line is an illusion: only the scale has changed.



Investors rely on log charts because they seek percentage gains, not nominal increases in wealth. To illustrate: the graph at right shows NASDAQ both on a linear scale and a log scale. The blue parabolic shape looks highly dangerous. Surely only the suckers jumped in at 5000, right before the crash. But, the log trendline shows that the NASDAQ grew more slowly in the period from 1987 to 1998 – when the parabola was forming – than in the period from 1975 to 1987. The spike at the end was merely catching up to the trendline growth.



The NASDAQ peaked on March 9, 2000, ending a spectacular 26-year run. But, what if the market had continued just 10% longer before crashing? Continuing the 1974 trendline, that extra 10% of time would have translated into an additional 58% return. The nervous nellies selling in 2000 would have left 37% of the gains from the entire 28-year bull market on the table.

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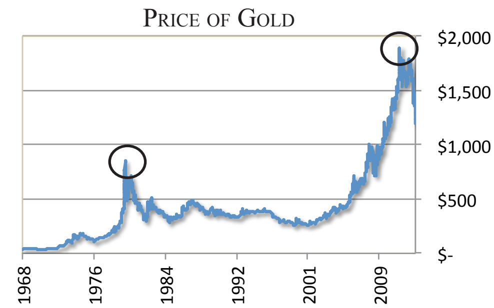
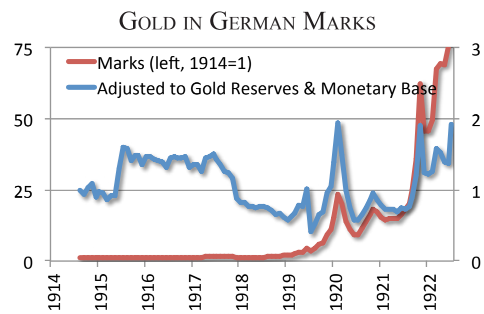
The hypothetical above reveals why parabolic markets are so enticing but dangerous. Parabolas are fractals in that they are infinitely self-similar: lengthening the x and y access simultaneously keeps the shape precisely the same, since they reflect merely a straight line on a log scale. No less than Isaac Newton was trapped by the parabolic market of the South Sea Bubble, in which he made a fortune selling early, but then was sucked back in at its peak as all the fools around him grew even richer then he.



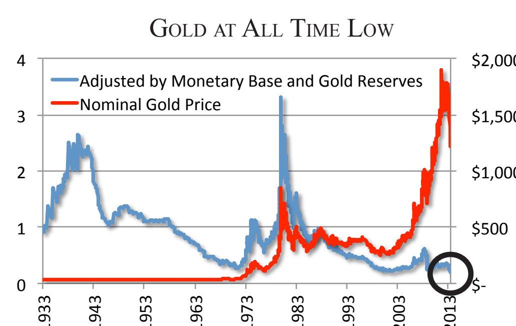
Gold investors may well empathize with Newton as the chattering classes celebrate the end of the gold bull market. Looking at the price chart of gold reveals two parabolic shapes: the first in the late 1970s and the second since 2001. The peaks of both are clear in retrospect, and more than one market commentator has highlighted the similarity: only idiots bought in at $1900.



But, there is a stark difference in the two peaks. "Prices" are a comparison of one thing to another. Pricing gold in dollars says just as much about the value of a dollar as the value of gold. Perhaps the best known, extreme example to illustrate this point is the price of gold in Weimar marks. As the red line shows, the price of gold in marks increased over 100 times from 1914 to 1922. Of course, the value of gold wasn't changing – gold in terms of dollars or British pounds remained the same – it was the mark that was falling.

One indication that the rising price of gold reflected the mark's demise as opposed to a sudden scarcity of the yellow metal is the blue line, which records gold's relative strength as against the German monetary base adjusted for its gold reserve. For example, if the monetary base doubles on the basis of discounting worthless domestic bonds and with no increase in gold reserves, one would expect the price of gold to double. Every time the blue line crosses 1 on the right axis, it means the market price of gold is has adjusted precisely to the changes in the monetary base/gold reserve from 1914.

After a long period of underperformance by gold in terms of the monetary base, gold shot up parabolically in 1919. By 1920 gold was expensive in nominal and relative terms and crashed 60% four months later. After the crash, even though gold remained 10 times higher in nominal terms than it had been in 1914, it had become very cheap in a relative sense, meaning it was a great time to buy. As late as mid-1921, when the hyperinflationary policies should have been obvious to all, gold remained cheap in terms of monetary base. But, within two years gold would be at 84,000 marks heading to the trillions.



The United States has also been engaged in runaway monetary growth through the QEs, though the printing began nearly a century ago, albeit at a more modest pace. The chart at right is calculated the same way as the chart of gold in Weimar marks and illustrates the difference between the gold peak in 1980 and the peak two years ago. In 1980, the price versus the monetary base reached an all-time high. Whereas, at the peak in 2011, gold stood only at one-third the level it had been in 1933 when Roosevelt confiscated and revalued Americans' gold.

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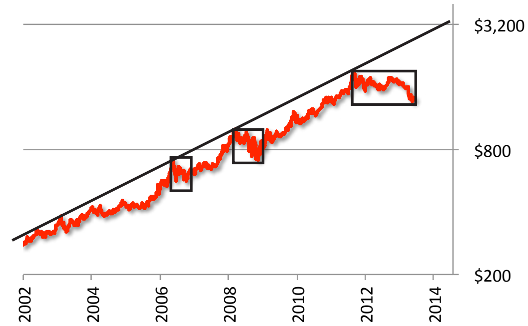
Except for the time scale, the graphs of gold in terms of the number of dollars and Weimar marks are frighteningly similar. A long period of underperformance after leaving the gold standard, followed by an initial spike in real and adjusted terms, and then consolidation before the next spike higher. The difference is that the second big spike in marks was in terms of the monetary base as well. Incredibly, even though gold remains above $1200, thirty-five times higher than in 1971, it sits at an all-time low as against the U.S. monetary base.

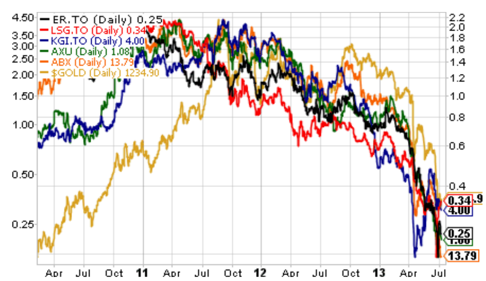
This bears repeating: gold has never been lower in terms of the monetary base than it is currently. To return to its adjusted level from 1933, gold would have to trade at $6,270 an ounce. Even so, the current correction is not abnormal. Log charts are also useful because they adjust nominal corrections to percentage corrections. The three boxes on the chart at right are exactly the same height, which means the magnitude of the current correction is slightly larger than in 2006 and exactly the same as in 2008, though over a longer period.

Gold Log Scale



The other thing to notice on the gold log chart is the rising resistance line and how remarkably straight the gold bull market has been. A year from now, gold's rising log resistance line will be above $3300. Two year from now the figure rises over $4100: this is the nature of exponential growth. All the money needed for gold to reach these levels has already been printed. If gold ever breaks this trendline, the dollar will be in hyperinflation.

Low gold prices are an incredible opportunity for those with liquidity to add to their positions, especially in the imploding gold mining stocks. Recent performance recalls Hemmingway's observation on how bankruptcy arrives: "It Happens Two Ways: Gradually, Then Suddenly." The graph at right shows the recent price performance of four junior gold mining companies, industry bellwether Barrick, and gold. This chart is on a log scale: the increasing steepness of the line reveals that the *velocity* of the decline has been accelerating for the past two years.



When gold bottoms and bounces, there is little doubt that most of the gold stocks will follow gold straight up the same curve. The lower chart shows the very same stocks during 2008. All of them reached significant new highs within two years. Except for the time scale, the two graphs are indistinguishable.

There is an old traders' adage: "don't try to catch a falling knife." Plunges such as the ones depicted on the graphs above are similar to the parabolas of bull markets in that they can continue indefinitely, being fractal-like objects. Just as an extra 10% of time in a bull market can add 58%, so a an extra 10% of time in the correction can erase another 58% before the bottom.

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Nevertheless, there are principles and values in markets to which prices must return, regardless of how far they stray. It is an error to suggest that the Fed's actions are unprecedented: in fact, they have been tried often throughout history. The best possible outcome at this point is a sharp devaluation that mitigates the unpayable debt, albeit with the cost of sacrificing savers and discouraging true capital formation for a decade. The worst case is societal capital consumed in a hyperinflationary inferno, destabilizing not just capital formation but society itself. Either way, gold will seek its fair value: the lower it goes now, the greater the percentage upside.

In 1933 Robert Smitley wrote: "If one is to retain his place in the existing social scheme during a period of chaos, he cannot allow his neighbors or associates to know anything about hoarded gold. The act becomes violently anti-social. The hoarder automatically becomes an outcast. He is at the mercy of pillagers and every man becomes his enemy." The opprobrium the chatterers hurl at gold investors should be no surprise, but even so the gold trade has theory and history on its side.

Diogenes the Cynic's response to Zeno was in its way more elegant than Aristotle's: he stood and walked. Gold will disprove the cynics by trading vastly higher as global central banks lose control of their domestic bond markets.

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